LIBRARY
SUPREME COURT, U.S.

Office-Supreme Court, U.S.
FILED
JUL 19 1965
JOHN F. DAVIS, CLERK

No. [redacted] 110

IN THE

# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1964

---

I. L. VAN ZANDT AND RUTH B. VAN ZANDT,
*Petitioners*

*vs.*

COMMISSIONER OF INTERNAL REVENUE

---

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

---

## Petitioners' Reply to Memorandum for the Respondent in Opposition

---

R. B. CANNON
*Attorney for Petitioners*

*Of Counsel:*
WEEKS, BIRD, CANNON & APPLEMAN
525 Fort Worth National Bank Building
Fort Worth, Texas 76102

Fort Worth Brief Printing Co., 610 S. Jennings Street Phone ED 2-4070

# INDEX

Page

Contentions in Respondent's Memorandum in Operation ..... 1–2

Petitioners' Reply to Respondent's Contentions

a. Petitioners' Reply to Respondent's First Contention ..... 2–10

b. Petitioners' Reply to Respondent's Second Contention ..... 10–11

c. Petitioners' Reply to Respondent's Third Contention ..... 11–13

d. Petitioners' Reply to Respondent's Fourth Contention ..... 13–16

Conclusion ..... 16

## CITATION

*Cases:* Page

W. H. Armston Co., Inc. v. Commissioner,
5 Cir. 188 F. 2d 531 ..... 2, 12, 15

Helen C. Brown v. Commissioner, (1950) 180 F. 2d 926
(C. A. 3) reversing 2 T. C. 1095, Cert. den.
340 U. S. 814 ..... 2, 14, 15

Clay B. Brown; Commissioner v. 85 S. Ct. 1162
(1965) p. 1170-1172 ..... 3

Hall v. U. S., 208 F. Supp. 584, p. 587 (N. D. N. Y. 1962) ..... 13

Helvering v. Clifford, 309 U. S. 331 (1940) ..... 6, 7

Ingle Coal Corporation v. Commissioner, 174 F. 2d 569
(C. A. 7, 1949), affirming 10 T. C. 1199 (1948) ..... 12, 14

Henry Kirschemann v. Harry C. Westover,
DCSD, Calif. (June 30, 1952) ..... 12, 14

A. A. Skemp v. Commissioner (1948) 168 F. 2d 598
reversing 8 T. C. 415 ..... 2, 13, 14, 15

Unger v. Campbell, 7 A. F. T. R. 2d 547
(N. D. Tex. 1960) ..... 13

White v. Fitzpatrick, CCA 2nd (1951) 193 F. 2d 398 ..... 12

*Statutes:*

Internal Revenue Code of 1954
Sections 671 to 678 ..... 3, 4, 7, 9, 10, 15

*Miscellaneous:*

Clifford Regulations-Treasury Decision 5488;
1946-1 CB 19 ..... 6, 7

Rev. Rul. 54-9, 1954 CB 20 ..... 4, 13

Rev. Rul. 57-315, 1957-2 CB 624 ..... 4, 14

82d Cong. 2d Sess., S. Rep. 1622 (1954) 86 ..... 7, 8

No. 1133

IN THE

# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1964

I. L. VAN ZANDT AND RUTH B. VAN ZANDT,
*Petitioners*

*vs.*

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

## Petitioners' Reply to Memorandum on Behalf of the Respondent in Opposition to the Petition for Certiorari

### RESPONDENT'S CONTENTIONS

The MEMORANDUM FOR THE RESPONDENT IN OPPOSITION to the granting of Certiorari in this proceeding essentially was grounded upon four contentions, viz:

1. That the payments made by Dr. I. L. Van Zandt to the trusts were not "ordinary and necessary" business expenditures, because "lacking in economic substance," and entered into for no other reason than to "shift income" to the trusts;

2. The Court of Appeals did not have occasion to consider the Government's alternative argument that the payments were not deductible because, in opinion of the Government, the Van

Zandts had an "equity" in the properties for the use of which the payments were made;

3. The result reached below was in accord with *Armston Co. v. Commissioner*, 188 F. 2d 531 (C. A. 5) and the other authorities cited in section 2, page 4, of Respondent's Memorandum in opposition; and

4. Despite the Commissioner's statement in Rev. Rul. 54-9 (1954 Cum. Bull. 20) and Petitioner's argument to the same effect, the decision in this case does not conflict with *Skemp v. Commissioner*, 168 F. 2d 598 (C. A. 7) or *Brown v. Commissioner*, 180 F. 2d 926 (C. A. 3).

We will deal with the foregoing contentions by Respondent Seriatim.

## PETITIONERS' REPLY

(a) We say to this court that the mere fact that the practical operations of the trusts was to cause the trusts to be taxable upon income which, but for the existence of the trusts and Petitioner's dealings with them, would have been taxable to Petitioners is not adequate grounds for treating the creation of the trusts and Petitioner's transactions with them as "lacking in substance." The trusts were held by the Court of Appeals to constitute separate entities. The same result would have followed from transfers to any other separate entity.

If (to use Respondent's terminology) there was a "shifting of income," the right to do so was not only approved, it was deliberately created by the Congress

(Sec. 671 to 678 IRC 1954). Certainly no more of a "reallocation of income" occurred in the case at Bar than occurs when income producing securities are transferred for a period of ten years or more to a trust containing identical terms and conditions as those involved in this proceeding, with the unquestionable result that after such transfer the income from the securities becomes taxable to the trust for its duration, and not to the grantor. Basically, then, Respondent's real quarrel is with the tax effects of statutes (Sections 671 to 678 I.R.C. 1954) dealing with Grantors, their Trusts, and the Beneficiaries of such Trusts, enacted by the Congress after years of deliberation and observation of the working of prior statutes in this field, and Treasury decisions, Internal Revenue Rulings and court decisions interpreting such statutes. If the respondent is not in accord with the tax results of the revisions effected by the Internal Revenue Code of 1954, Respondent should look to the Congress, and not this Court, to remould the taxing acts more to Respondent's liking.[1]

With regard to Respondent's charge that the trusts and Dr. Van Zandt's dealings with them were lacking in substance, the Court of Appeals below in its opinion and decision among other things (see page 41—part of Appendix B—of the Petition for Certiorari in which the opinions below were reproduced in full) said:

> "Each trust was made irrevocable for a term of ten years and two months. The instruments

[1] *Commissioner v. Clay B. Brown, et al.*, 85 S. Ct. 1162 (1965) pp. 1170-1172.

> also contained the minimum requirements under the pertinent federal statutes which would prevent the income of the trusts from being income of the donors. Section 671 to 678, inclusive, Internal Revenue Code 1954."

The Court also said (see page 47 of the petition for certiorari):

> "Although the question is not before us, we recognize that from the standpoint of taxability of income of the trusts, not deductions which the payor of that 'income' may take, this was a perfectly valid trust. It met not only the minimum, but *all* of the statutory tests so that its income will be taxed to it, not to donors." (emphasis supplied)

Inherent in the foregoing language is the recognition by the Court of Appeals that Petitioners had divested from themselves, and vested in the trusts, such an interest in the properties involved that, under express provisions of the trust instruments in order to use or occupy such property petitioners were required to, and did, pay a fair and adequate rental therefor which, upon receipt: (i) vested irrevocably in the beneficiaries of trusts; (ii) was specifically found by the Court of Appeals to be taxable to the trusts; and (iii) which petitioners could never recoup.[2] Certainly transactions having all of the fore-

[2]The holding by the Court of Appeals that petitioners payments to the trusts were income taxable to the trusts (although not deductible by petitioners), vis-a-vis the ruling by the Internal Revenue Service Rev. Rul. 54-9, 1954 Cum. Bull. 20; Rev. Rul. 57-315, 1957-2 Cum. Bull. 624) that similar payments were gifts posed a dilemma for respondent which he attempted to meet by riding, circus fashion, with one foot on each of the two horses, i.e., in subdivision 1 of his memorandum at page

going substantial effects properly cannot be said to be "lacking in substance."

A proper appraisal of the soundness or lack of soundness of the holdings of the Courts below that the creation of the trusts here involved and petitioners' dealings with them were "without substance" and constituted a "mere reallocation of income", condemned by earlier court decisions under prior revenue statutes (since amended) as without substance which not only might, but must, be ignored in fixing petitioners' correct income for the years here involved (which are the taxable years 1958 and 1959) requires a review of the legislative and judicial history of the trust provisions of the Internal Revenue laws, past and present.

The statutory provisions of the early taxing actions dealing with trusts and grantors and beneficiary were few in number and those few were woefully vague. The attempt to produce definitive guide lines for the administration of such statutes through litigating disputed issues as they arose was found to be unduly cumbersome, productive of little light and, on occasion, even more confusion. How best to attain uniformity in this field, how to free the ascertainment of liability from dependence on the whims and foibles of individuals in the Treasury Department and in the Internal Revenue Service (particularly those charged with

---

2, he said: "Petitioners admittedly divested themselves of the minimum powers necessary to take the trusts' income, *if any* (the Court of Appeals below had held petitioners payments to the trust to be income taxable to the trusts) out of their returns and make the trusts taxable as separate entities" (emphasis supplied) then followed this by saying on the next page of the memorandum in opposition (p. 3) that: "The payments constitute gifts and not necessary expenses."

drafting Regulations and Rulings) and, for that matter, from the conflicting viewpoints of various judges, was a project which engaged the earnest attention of the Treasury Department and the Internal Revenue Service (then known as the Bureau of Internal Revenue) and the Congress over a period of years and the program was still in progress in 1940, the year in which the landmark case of *Helvering v. Clifford*, 309 U.S. 331 was decided by the Supreme Court of the United States.

It is a matter of history that the decision of the Supreme Court in *Helvering v. Clifford, supra* was followed by a spate of Internal Revenue fiats and lower court decisions dealing with the tax effects of transactions between trusts, their grantors and beneficiaries, seeking to apply what the administrator or the lower court, as the case might be, conceived to be the *Clifford* doctrine to facts and circumstances varying in some one or more particulars from those before the Supreme Court in the *Clifford* case. In the judicial decisions handed down during this period, following a wide variety of reasoning and attaching differing weight to this, that or the other factor present in the particular case before them, the lower courts reached such varying results that, just as it was before *Helvering v. Clifford, supra*, neither the government nor the taxpayer knew with any certainty where they stood in any particular situation.

In an attempt to bring order out of this chaos, the Treasury Department under date of December 29, 1945 promulgated the so-called "Clifford regulations"

(Treasury Decision 5488; 1946-1 CB 19) attempting to provide what *it* then considered proper guidelines in the field. However, after the Clifford Regulations had been in effect for several years, being dissatisfied with the effect and applications of portions of the "Clifford Regulations", and giving cognizance to uneasiness on the part of taxpayers occasioned by the fact that Treasury Regulations are capable of being enlarged, contracted or revoked at the whim of the Treasury Department as easily as they can be promulgated in the first instance, the Congress in 1954, convinced that the rules for determining the circumstances under which the grantor of a trust should be treated as the "substantial owner" of the trust (deemed the controlling tax factor in *"Clifford"* and related cases) should be set forth in the statute rather than left to administrative regulations and rulings, proceeded to incorporate in the Internal Revenue Code of 1954 Subpart E of the Code consisting of Sections 671 to 678, inclusive (set out verbatim in appendix "A" to the petition for certiorari at page 11 to 25). The aforementioned sections, considered as a whole, outlined in detail under just what circumstances, and only under what circumstances, grantors and others could and should be treated as "substantial owners" of trusts, and, for the purposes of the income tax, the assets and dealings of such trusts should be treated as those of the Grantor.

The intent and purpose of the Congress in enacting Sections 671 to 678, IRC 1954 was concisely stated in the "general report" on Subpart E which accompanied the bill (82d Cong. 2d Sess., S. Rep. 1622

(1954) 86) and read in part as follows:

> "Existing law contains a statutory provision dealing with trusts in which the grantor retains a power of revocation and also a provision dealing with trusts whose income is accumulated or used for the benefit of the grantor. In addition, regulations (commonly known as the Clifford Regulations) provide a series of rules to determine when trust income is to be taxed to the grantor because of: a reversionary interest within a specified period; powers to control the beneficial enjoyment; or certain broad administrative powers. These regulations are based on the assumption that the grantor may be taxed under the general definition of income. If the grantor retains such elements of control, *he is deemed to be the owner* even though the trust is irrevocable. (emphasis supplied)
>
> "Your committee believes that the rules for determining when the grantor should be treated as the substantial owner of the trust should be set forth in the statute rather than left to regulations. Thus, the bill includes specific provisions to this effect in the estate and trust chapter * * * * *"

In the Internal Revenue Code of 1954, the "independent trustee" concept was abandoned,[4] and in lieu

[4]Anyone with a reasonable amount of experience in administration of trusts knows that, absent controlling conditions and limitations in a trust instrument, the trustees are subject to various pressures from grantors and beneficiaries; and, unless restrained by specific provisions in the trust instrument, are prone to respond to such pressures. Because of this in enacting the trust provisions of the Internal Revenue Code of 1954, the Congress wisely shied away from *labels* and incorporated in the statute its own specific rules as to what actions on the part of trustees would cause the trust to lose its separate identity, and its properties and income regarded as those of grantor.

thereof, prohibited conduct by trustees was spelled out in detail (sections 674 and 675, Internal Revenue Code 1954); reversionary interests were dealt with in section 673 of the code which provided in substance that the retention by the grantor of a reversionary interest in the trust principal that reasonably could not be expected to result in the reacquisition of the trust corpus within less than ten years (in the case of a certain charitable beneficiary, this time was reduced to two years) would, as far as dealing between the grantor and the trust were concerned, be treated as if grantor retained no strings on the property whatsoever.

In the light of major shifts in approach and in underlying philosophy introduced into the Revenue laws by Sections 671 to 678 inclusive of the Internal Revenue Code of 1954, in seeking to determine the applicability to issues arising under the Internal Revenue Code of 1954 of Court decisions rendered under earlier Revenue laws, particularly those decisions which turned upon whether, in the opinion of the Court, the trustee or trustees involved were or were not "independent" or whether grantor did or did not retain such strings on trust assets as to require him to be deemed the "owner" of the trusts (ie, reversionary rights, etc.), care must be taken to evaluate those decisions in the light of the differences in the criteria applied by the court in reaching its conclusion in such earlier cases and the criteria substituted therefor in the Internal Revenue Code of 1954.

It is also important to recognize that in enacting the Revenue Code of 1954, it was not necessary for the Congress to deal with the matter of deductions arising out of dealings between grantors and trusts created by them because, if the income of the trusts were taxable to grantor, payments giving rise to deductions to grantor would be required to be included in the income of the trust taxable to grantor, with the result that the deduction and the offsetting income inclusion each would cancel out the other.

Construed in their entirety, sections 671 and 678 inclusive of the Internal Revenue Code of 1954 require that when specific standards laid down therein are fairly complied with, grantors and their trusts must be recognized as separate entities and, where dealings between them are conducted in a manner which fully complys with the controlling provisions both of the statute and of the trust instrument or both as the courts below found had been done in the case at bar, such dealings should be accorded the same treatment accorded similar transactions between wholly unrelated parties. So treated, the rents paid in the case at bar are deductible from petitioners' income.

(b). We will next deal with the assertion at footnote 1, page 3, of the memorandum on behalf of the respondent in opposition, that the Court of Appeals did not have occasion to consider the government's alternative argument that the rental payments involved in this case should be disallowed because petitioners had "an equity" in the trust properties.

If respondent means by footnote 4 that this issue

was not fully presented to the Court of Appeals, the government's brief in the Court of Appeals establishes otherwise. The respondent's alternative contention was fully presented to the Court of Appeals in respondent's brief below (under "ARGUMENT"—Subdivision E, page 18) and such contention was also fully dealt with in oral argument before the court by counsel when the case was heard in the Court of Appeals.

We respectfully submit that a probable reason for the failure of the Court of Appeals to mention such contention in its opinion was that this contention is without merit and was so considered by Court of Appeals below.

We say that respondent's alternative argument is without merit because, by the respective transfers in trust the title to and ownership of the properties transferred was divided into two separate and distinct estates, viz: (i) an estate for a period of ten years and two month and, (ii) a remainder interest. The petitioners had no "equity" in the estate for ten years and two months which was vested in the trusts, and by virtue of the rentals paid by them, petitioners acquired no interest or equity *in such estate for years* other than the right, as tenants, to occupy and use the property in question during the estate for years so long, and only so long, as they made the rental payments specified in and required by their leases from the trusts.

(c): Only in a single and very minor degree is the result below in accord with the authorities cited in

subdivision 2 at page 4 of the memorandum for the respondent in opposition. Such sole similarity is limited to the fact that in each of those cases the taxpayer involved was denied deductions from income claimed in his, its or their returns.

Such deductions were denied under varying fact circumstances and for varying reasons. In *W. H. Armston and Co. v. Commissioner* excessive payments made by a corporation to its sole shareholder were disallowed as representing distributions of corporate income rather than rents; in *White v. Fitzpatrick* the underlying question (193 F. 2d 398 at page 401) was whether certain transfers in trust made under the Internal Revenue Code of 1939 were sufficient to transfer "ownership" to the donee trust tested by criteria established by the Internal Revenue Code of 1939 and Court decisions and Treasury Regulations and Rulings promulgated under that statute or prior Revenue statutes (all amended *by IRC* 1954). Under the facts in *White v. Fitzpatrick* the majority of the Court (Chase, Cct. Judge dissenting) held that the payments were not deductible but in arriving at such conclusion stated that in its view, whether the question involves the deductibility of a payment or the taxability of income received, the line to be drawn is the same in the field of deductibility as it is in the field of to whom income is taxable. *Kirschenmann v. Westover, Collector of Internal Revenue,* involved unreasonable rents (ie, excessive in amount) paid and received between related parties; *Ingle Coal Corporation v. United States* involved the question whether, under the facts involved, transactions between the corpora-

tion and its stockholders amounted in substance to deductible royalty payments or whether such payments were in substance taxable dividends to the corporate shareholders not deductible by the corporation; in *Hall v. United States* the trust there involved was not for any particular term certain because the death of any grantor or beneficiary immediately voided the trust instrument. The *Hall* case arose under the Internal Revenue Code of 1954, and except for *Unger v. Commissioner* was the only case cited by Respondent which did arise under the Internal Revenue Code of 1954. The decision in the *Hall* case was correct, not for the reasons given in the opinion of the Court, but because the trusts there involved had no fixed duration as the death of *a grantor* or *any beneficiary* immediately voided the trust instrument. See: 208 F. Supp. 584, page 587; the *Unger* case, turned upon the view of the trial judge (the case was tried without a jury), that the evidence conclusively showed that a purported sale of equipment by Unger to his elderly mother followed by the leaseback of the equipment to Unger was a sham transaction, because Unger consistently ignored the terms of his contracts with his mother and never intended that she enjoy the full fruits of her purported purchase.

(d) In subdivision 3, page 4 of the memorandum for the respondent in opposition respondent contends that despite petitioners' argument and the Commissioner's statement in Rev. Rul. 54-9 (1954-1 Cum. Bull. 20) to the contrary the decision in this case does not conffict with *Skemp v. Commissioner*, 168 F. 2d

594 (CA 7) or *Brown v. Commissioner*, 180 F. 2d 926 (CA 3).

This contention represents an abrupt about-face on the part of the taxing authorities. In 1954 the Commissioner of Internal Revenue, in a ruling which bears intrinsic evidence of having been drafted by legal counsel as opposed to administrative assistants, ruled that, under a transfer in trust to a ten year trust with lease back to the grantor, for purposes of Federal income and gift taxes the rental payments made by the grantor would not be deductible by grantor, but would constitute taxable gifts by grantor to the trusts. In this ruling, after discussing various court decisions, concluding with *Henry Kirschemann v. Harry C. Westover*, DCSD, Calif. (June 30, 1952; then pending on appeal), it was stated that "a contrary result was reached in *A. A. Skemp v. Commissioner* (1948) 168 F. 2d 598 reversing 8 T. C. 415 and *Helen C. Brown, et al v. Commissioner* (1950) 180 F. 2d 926 reversing 2 T. C. 1095, Cert. den. 340 U. S. 814 * * * * * * * * *." and further —

"It is believed that the *Skemp* and *Brown* opinion in the Court of Appeals conflict in principle with *W. H. Armston Co., Inc. et al v. Commissioner* (1951) 188 F. 2d 531; * * * *; *Ingle Coal Corp., supra.*" etc.

The foregoing Revenue Ruling was modified in 1957 by Rev. Rul. 57-315; 1957-2 C. B. 624, to hold that the present value of the right to receive the rentals for the entire period of the lease constituted a gift for the year the trust was executed (rather than the rental payments being treated as gifts when made )

but in no other respect. Thus, for approximately a decade the Internal Revenue Service has proceeded on the premise that *W. H. Armston Co., Inc. v. Commissioner*, 188 F. 2d 531 (CA 5), the sole authority cited in the opinion of the Fifth Circuit in its decision in the case at bar, was in conflict with *Skemp v. Commissioner* and *Brown v. Commissioner*, *supra*, and gift taxes have been assessed and collected pursuant to that assumption.

An analysis of *Armston*, *Skemp* and *Brown*, *supra* clearly reveals direct conflict between *Armston* and the holding in *Skemp* and *Brown* and, therefore, with the case at bar. Moreover, after a decade of conceding in his published rulings that such conflict existed, it seems rather late for the Commissioner of Internal Revenue, through his attorney, the Solicitor General, to represent to this Court that no such conflict exists.

The attempt in the balance of subdivision 3 at page 4 and 5 to contend, on the basis of criteria antedating the enactment of the Internal Revenue Code of 1954, that Petitioners in substance retained full control and ownership of the properties does not warrant serious consideration, particularly in the light of the finding by the Court of Appeals for the Fifth Circuit below that the trusts were valid, met all of the requirements of Sections 671 to 678 inclusive of the Internal Revenue Code of 1954, and that the rental payments made were taxable to it and not to the settlors.

We know of no case, other than the case at Bar, where any *court* has held, or even expressed the view, that payments made by a grantor to a trust were at

one and the same time (i) not deductible by payor but (ii) taxable income to the recipient. To affirm the decisions below would have the effect of overturning many years of consistent administrative adherence to the principle that, for income tax purposes, (a) if a payment is deductible by payor, the amount is includible in income of recipient; (b) if not deductible by payor, it is not taxable income to payee.

For the foregoing reasons, and those set out in the petition for a writ of certiorari, the petition for a writ of certiorari should be granted.

Respectfully submitted

---

R. B. CANNON
525 Fort Worth National Bank Bldg.
Fort Worth, Texas 76102
*Attorney for Petitioners*

July, 1965